



May 6, 2011

By Electronic Mail

Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, DC 20551

Re: Request For Comment: Prohibition Against Payment of Interest on Demand Deposits

(RIN No: 7100-AD72)

In response to your request for comment regarding the Repeal of Regulation Q, Treasury Strategies, Inc. (TSI) has prepared the following opinion. Treasury Strategies is the leading Treasury consulting firm working with corporations and financial institutions in the area of treasury, liquidity, and payments. Since the enactment of Dodd-Frank, Treasury Strategies has conducted regulatory response planning efforts with numerous financial institutions, which in aggregate, comprise over 40% of total U.S. banking deposits.

Enacted in 1933 as part of the Glass-Steagall Act, Regulation Q prohibits the payment of interest on corporate checking accounts and has been part of the commercial banking regulatory landscape for over 75 years. The bill to repeal Regulation Q was introduced by Rep. Scott Murphy in November 2009 under the title *The Business Checking Fairness Act*, but was eventually inserted as an amendment to the Dodd-Frank bill. In a statement issued by Rep. Murphy, he stated that he introduced the Business Checking Fairness Act to, "level the playing field for small businesses, giving them access to more capital and increasing their job creating potential."

Unlike prior attempts to repeal Regulation Q, the amendment that added Murphy's proposal to Dodd-Frank received relatively little debate. Neither the House nor the Senate contemplated the validity of Murphy's claims and there was no attempt to fully assess the economic impacts of fundamentally altering the commercial banking industry. According to the bill's sponsors, the intended benefits of repealing Regulation Q repeal are:

1. Increased small business growth due to the interest earnings on their cash assets.
2. Enhanced effectiveness for small depository institutions in competing for commercial balances.

The repeal of Regulation Q fails to meet its stated benefits of helping small businesses and community banks.

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Potential Negative Impact to Small Businesses

Treasury Strategies' research indicates that the typical small business holds less than \$10,000 in its checking account. If a bank pays a 2% interest rate on these balances, a generous rate in today's environment, a typical small business would earn less than \$200 per year in interest. Obviously, \$200 in interest every year is hardly enough income for a small business to grow or add new jobs as suggested by Rep. Murphy.

Furthermore, banks are likely to increase the banking fees that they charge to business customers in order to make up for the added costs of paying interest on business checking accounts. If we assume a relatively low monthly service fee of \$25, or \$300 annually, the net result to the small business earning interest on its checking account would be a cost of \$100 per year. Therefore it becomes clear that the repeal of Regulation Q will do nothing to improve the growth of small businesses.

Reduced Ability for Community Banks to Compete

Community banks often rely upon attractive interest rates in order to attract customers away from larger banks, which may offer a broader array of services. So, the thinking behind the repeal of Regulation Q was that by enabling community banks to pay interest on business checking accounts, they would be more effective in competing with larger financial institutions.

However, in reality, quite the opposite is true. Under the repeal of Regulation Q, community banks are handicapped in competing with larger financial institutions. By virtue of balance sheet size and geographic reach, community banks have less of an opportunity to deploy new funds than larger more geographically diverse competitors. As a result of these factors, the competitive position of small depository institutions declines.

Repeal of Regulation Q Harms All Businesses and Banks

Treasury Strategies' extensive research and analysis indicates that this legislation will also have detrimental impacts to businesses and financial institutions of all sizes. Some of the hidden macroeconomic dangers of the proposal include:

- Increased deposit volatility
- Increased concentration of financial assets in the banking sector
- Higher operating costs for both banks and businesses
- Contradictions with current and proposed banking regulations

The repeal Regulation Q will cause significant damage to businesses and banks of all sizes and the overall stability of the financial system as a whole.

Increased Deposit Volatility

The repeal of Regulation Q creates incentives for corporations to seek the most attractive interest rate, creating greater deposit volatility for financial institutions. In the current environment, businesses cannot receive interest on deposits, but they do receive notional earnings credits, which can be used to pay for bank services. This feature provides businesses with the benefit of being able to pay for bank services with deposit balances and provides the bank a more stable deposit portfolio. Businesses have an incentive to leave deposits with their service providers rather than actively seek rates, creating a more stable deposit portfolio for banks.

Interest-bearing balances are inherently more volatile than non-interest-bearing balances because the benefits (interest earnings) are unassociated with any stabilizing factors such as using balances to pay for services. The lack of stabilizing factors increases the level of “hot money” in the banking sector in instances where the competitive bidding up of interest rates results in offers above the equilibrium level. The artificial inflation of interest rates increases the risk that a bank will experience an exodus of deposits if it lowers its interest rates amidst one of these bidding wars. Prior to the enactment of Glass-Steagall, this was less of a risk due to the fact that moving deposits between banks was a very manual process. However, in today’s electronic environment, this risk is enormous given that a business can quickly transfer funds between institutions with the click of a button.

Increased deposit volatility will also further exacerbate financial system risk by increasing the likelihood that a bank will suffer a liquidity crisis or fail to meet stable funding requirements. The increased risk is counterproductive to current regulatory agendas proposed and enacted by the Basel committee and the FDIC and does not meet the stated objective of the bill’s sponsors of improving the competitive position of small banks. In fact, the bill makes it more likely that small banks will face increased liquidity risk and higher funding costs at a time when they are already suffering.

Treasury Strategies’ research indicates that up to 60% of commercial clients consider an interest-bearing account to be an optimal solution, all else being equal. This indicates that the risk of increased deposit volatility is very real. Businesses view interest-bearing accounts as viable alternatives to their current deposit operating accounts.

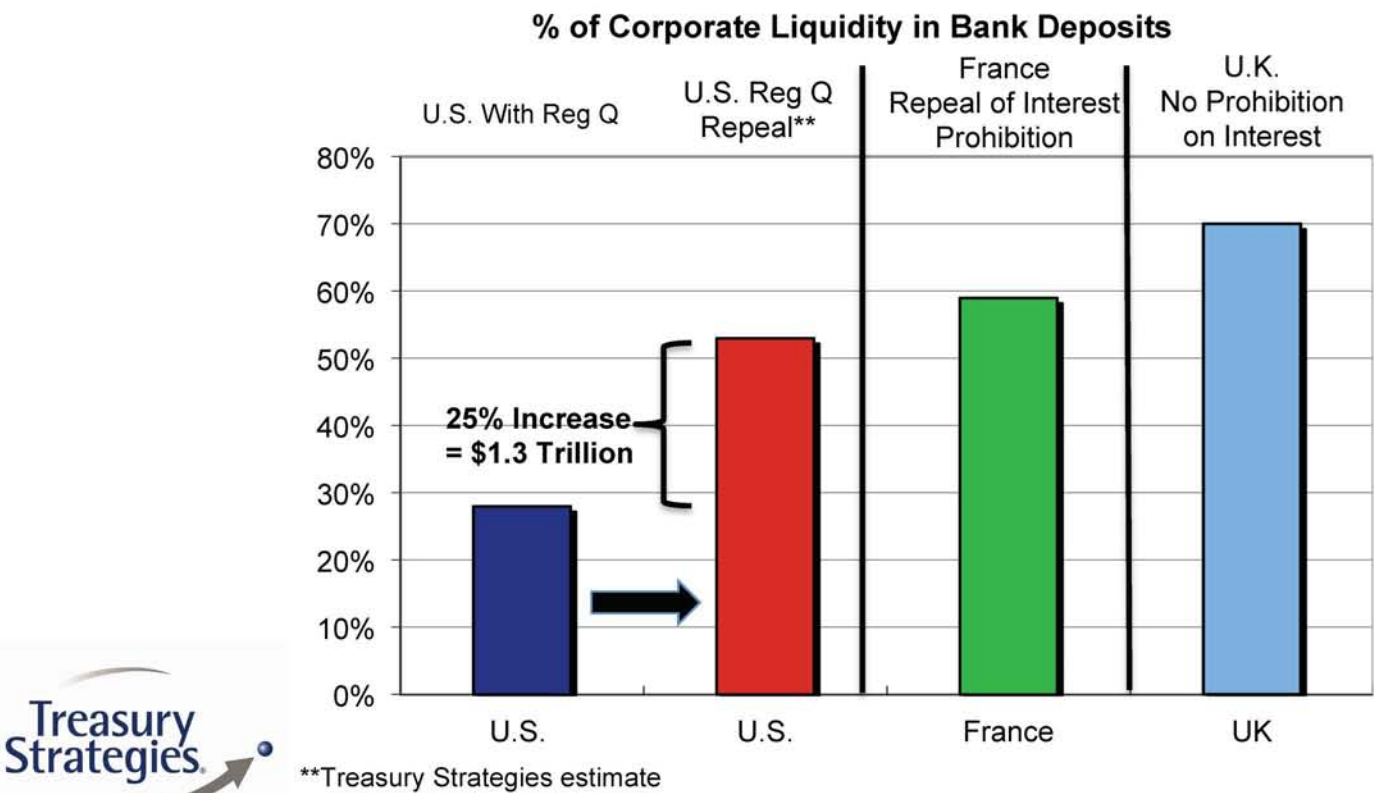
Increased Concentration of Financial Assets within the Banking Sector

Bank balance sheets are currently flush with deposits as evidenced by the \$1.5 trillion in excess reserves currently held by banks with the Federal Reserve. Additionally, Treasury Strategies' Corporate Liquidity research indicates that corporate treasurers currently hold an all-time high of 28% of their liquid assets in bank deposits. If the repeal of Regulation Q proceeds as planned, corporations could increase their bank deposits by a significant amount, as evidenced by the experiences of other countries with similar laws.

For example, France recently repealed a similar prohibition on interest payments for corporate checking accounts in 2004 and corporations reacted by increasing their percentage of bank deposits from approximately 40% to 60% of their liquid assets in the following years. Banks have the advantage of being able to arbitrarily set interest rates, which allows them to effectively attract assets away from MMFs as investors seek to maximize yield. Assuming a similar increase in bank deposits for corporations in the U.S. would amount to approximately \$1.3 trillion (See Figure 1) in new balances flowing onto bank balances sheets.

This significant increase in corporate bank deposits would increase the concentration of financial assets within the banking system. This further exacerbates the problem of too big to fail.

Figure 1



Higher Operating Costs for Banks and Businesses

Banks typically use deposits to fund their lending activities. The introduction of interest-bearing deposits raises the cost of funding by changing some portion of non-interest-bearing deposits to interest-bearing deposits. This will lead to the following consequences:

Less Efficient Money Markets: As stated in the prior section, the concentration of financial assets in the banking sector will increase, resulting in non-bank money markets becoming substantially less liquid and less robust. Many corporations use a mix of money market instruments to meet their short-term funding needs such as meeting payroll, purchasing raw materials, etc. The primary purchasers of these securities are money market mutual funds (MMFs), which have a yield based on the return of their underlying assets. With less liquidity in the money markets, corporations will either have to pay higher yields on the securities that they issue or turn to banks to satisfy their short-term funding needs. It is highly unlikely that banks would be willing to satisfy even a portion of the \$1.3 trillion of short-term liquidity at current spread levels. We would thus expect the spread levels on credit offerings to widen.

Higher Costs of Credit: Banks can adjust the cost of providing credit to commercial customers by charging higher rates on loans. The increases in credit costs to commercial customers will be significant if large portions of deposits are converted to interest-bearing accounts.

In order to attract investors and to offset the costs associated with interest-bearing deposits, some institutions might also resort to loosening their lending requirements. The high-cost funds and high-risk assets could create another perfect storm similar to the real-estate bubble of the mid 2000's.

More Expensive Products and Services: Banks are also likely to increase the cost of their products and services in order to offset the higher cost from paying interest on deposits. Currently many products and services are partially subsidized by the spread income the bank earns on the deposits that the services generate. To offset the lower spreads, banks will likely increase the costs of the products and services.

Contradictions with Other Active and Proposed Regulations

The repeal of Regulation Q is counterproductive to the Basel III proposals around liquidity coverage and stable funding, Basel III capital requirements. It also is at odds the new FDIC assessment methodology regulations designed to improve the liquidity, funding sources, and capital holdings of the banking industry.

Liquidity: Under the Basel III International Framework for Liquidity Risk Measurement, Standards, and Monitoring proposal and the new FDIC assessment methodology, banks are penalized for holding volatile deposits. As demonstrated above, repeal of Reg Q results in higher deposit volatility. Therefore, these regulations will force banks to maintain significant levels of cash or high-quality liquid investments in reserves, which decreases their ability to provide loans to business of all sizes.

Stable Funding: The Basel Committee recently proposed the creation of a Stable Funding Ratio¹ that would require banks to evaluate the liquidity profiles of their assets and liabilities to better align assets to deposit duration. Interest-bearing deposits receive a short-term duration and are not considered stable funds. These deposits could not be used to fund long-term assets and similar to the liquidity rules, would decrease the availability of credit to businesses of all sizes.

Capital: As mentioned in prior sections, the potential flow of deposits into interest-bearing checking accounts could severely strain bank capital levels, forcing banks to maintain ever-increasing levels of capital, resulting in lower returns on that capital.

The combined impact of these regulations along with the disintermediation of secondary markets will further exacerbate the need for banks to increase lending costs. The costs of bank products and services will also increase, which ultimately harms the very customers that the repeal of Regulation Q was purported to help.

¹ **Source:** Basel III International Framework for Liquidity Risk Measurement, Standards, and Monitoring, December 2010

Conclusion

The repeal of Regulation Q fails to deliver its promised benefits of increased small business growth and improved competitive positioning for Small Depository Institutions.

Instead of promoting economic growth and providing stability for banks and businesses alike, the repeal of Regulation Q adds further risks and costs to the financial system by:

- Increasing deposit volatility
- Increasing concentration of financial assets in the banking sector
- Creating higher costs of doing business for both banks and businesses
- Contradicting current and proposed banking regulations

There is no such thing as a “free lunch” and the repeal of Regulation Q attempts to adjust the equilibrium of the commercial banking market without regard to the consequences for banks or businesses. **Treasury Strategies urges the Federal Reserve to work with Congress to remove the repeal of Regulation Q from the Dodd-Frank Act, not just for small depository institutions, but for banks of all sizes. Failure to do so could result in damage to the effective operation of the U.S. commercial banking sector and overall economy.**

Sincerely,



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APPENDIX I — Background of Authors

Treasury Strategies, Inc. is the leading Treasury consulting firm working with corporations and financial institutions. Our experience and thought leadership in treasury management, working capital management, liquidity and payments, combined with our comprehensive view of the market, provides us a unique perspective and unparalleled insights into both the corporate and financial sectors. The fact that our clients include corporate investors, financial institutions, regulators, and fund companies is further evidence of our involvement within the money market fund industry. Anthony J. Carfang and Cathryn R. Gregg are Partners of Treasury Strategies. Jacob Nygren is a Manager at Treasury Strategies. Jonathan Talbert is a Consultant at Treasury Strategies.

